

TITLE 18. FRANCHISE TAX BOARD
AMENDMENTS TO PROPOSED
REGULATION SECTION 25136, RELATING TO
SALES OF OTHER THAN TANGIBLE PERSONAL PROPERTY

A hearing was held on August 10, 2011 by Melissa Potter of the Franchise Tax Board Legal Division, the "hearing officer," on proposed amendments to California Code of Regulations, title 18, section 25136 (Regulation section 25136), which was noticed in the California Regulatory Notice Register on June 17, 2011. This regulation is intended to provide guidance on assigning sales of other than tangible personal property where a taxpayer makes an election to use the single-sales factor formula and its market-based rules.

Department staff reviewed the proposed regulations and considered the comments submitted before and after the hearing. The hearing officer recommended that certain changes be made which were published in a 15-day notice on October 7, 2011. Nine (9) comments were received during the 15-day comment period. Based on some of the comments received, further 15-day changes are now proposed to be made. A definition has been added for the term, "Complete transfer of all property rights." One modification consists of minor adjustments to the facts in an example. Adjustments for clarification have been made in the provisions for assignment in the case of the sale of stock. There is one change that is proposed by staff, and that is deleting duplicative language in an example.

These nonsubstantial or sufficiently related changes (within the meaning of Govt. Code Section 11346.8) recommended by the hearing officer are reflected in the attachment hereto. These amendments to the regulation are reflected by underscore for additions and strikeout for deletions. Proposed changes to Regulation section 25136 are summarized below.

1. A definition for "Complete transfer of all property rights" has been added under the "General Definitions" section. Hence the numbering of the definitions in the Definitions subsection has changed. For example, "Complete transfer of all property rights" is now (b)(3) and "Intangible property" is now (b)(4) and so on. This numbering change is indicated by strikeout or underscore of the number or letter being removed and/or being added. The subsections referred to in these paragraphs refer to the newly assigned number or letter as assigned by this 15 day notice's proposed changes.

2. Subsection (b)(3) is now the definition for the term, "complete transfer of all property rights." This definition makes it clear that "complete transfer" means a transfer in connection with ownership rights of stock or an interest in a pass-through entity as distinguished from those rights transferred under a license. It is also made clear that "complete transfer" does not mean that a taxpayer's disposition of stock in a corporation or interest in a pass-through entity must be a transfer of 100% of its ownership interest in that entity in order to have its sale assigned under subsections (d)(1)(A)1.a and b.

(3) "Complete transfer of all property rights" means a transfer of all property rights associated with the ownership of intangible property, as distinguished from

a licensing of intangible property where the licensor retains some ownership rights in connection with the intangible property licensed to a buyer. A complete transfer does not require that a seller has sold all of its stock in a corporation or all of its interest in a pass-through entity; rather, it merely means that the seller retains no property rights in the stock or other interest that has been sold. For example, a seller who owns one hundred (100) percent of the stock of a corporation and sells sixty (60) percent of its ownership interest in corporation retaining no property rights in the stock sold, has engaged in a complete transfer of all property rights with regard to the 60% of the stock that was sold. The sixty (60) percent ownership interest sold is subject to assignment under subsections (d)(1)(A)1.a and b.

3. Subsection (c)(1)(C)1 provides an example of a sale or services to individuals. Language has been added to describe "net plant facilities." Language has also been added to indicate how the property is valued. The last sentence was deleted as confusing and unnecessary.

1. Benefit of the Service – Individuals, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address is not reflective of the location where the benefit of the services is received by the customer. Phone Corp has operating equipment and facilities used to provide communications services ("net plant facilities") located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services will be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services using a consistent methodology of valuing the property, for example, net book basis of the assets that is determined from Phone Corp's books and records. ~~Revenues from interstate and international calls will be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call.~~

4. Subsection (c)(2)(E)6 is an example for sales of services to a business entities. The phrase "or reasonably approximating" has been deleted because it is duplicative of the sentence below it and would potentially create confusion.

6. Benefit of the Service – Business Entity, subsection (c)(2)(C). For a flat fee, Painting Corp contracts with Western Corp to paint Western Corp's various sized, shaped and surfaced buildings located in this state and four (4) other states. The contract does not break down the cost of the painting per building or per state. Painting Corp's books and records kept in the normal course of business indicate the location of the

buildings that are to be painted but do not provide any method for determining ~~or reasonably approximating~~ the extent that the benefit of the service is received in this state, i.e. the size, shape, or surface of each building, or the materials used for each buildings to be painted. In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received. Since neither the contract nor Painting Corp's books and records indicate how much of the fee is attributable to this state and there is no method of reasonably approximating the location of where the benefit of the service is received, the sale will be assigned to this state if the order for the service was placed from this state.

5. Subsection (d)(1) is the segue for assignment of sales of intangible property where there has been a complete transfer of property rights. It has been modified to reference the definition of "complete transfer of all property rights" in subsection (b)(3).

- (1) In the case of the complete transfer of all property rights (as defined in subsection (b)(3)) in intangible property (as defined in subsection (b)(34)) for a jurisdiction or jurisdictions, the location of the use of the intangible property shall be determined as follows:

6. Subsection (d)(1) (A)1 provides the segue for the rules of assignment in connection with the sale of stock. To make it clearer that a seller need not own one hundred percent of the stock of an entity, nor sell all one hundred percent of its interest in order for the assignment rules of (d)(1)(A)1 to apply, the words "shares of" have been inserted in front of "stock." Also, in order to reflect the language of the statute, 25136(b)(2), which states that sales of marketable securities are in this state if the purchaser is in this state, the section is amended to add the phrase "other than sales of marketable securities".

1. Where the sale of intangible property is the sale of shares of stock in a corporation or the sale of an ownership interest in a pass-through entity, other than sales of marketable securities, the following rules apply:

7. Subsection (d)(1)(A)1.a. provides the assignment method where 50% or more of the underlying assets of the corporation or pass-through entity sold consist of real and/or tangible personal property. To make it clear that the determination of whether the underlying assets consist of 50% or more of real and/or tangible personal property is to be made on the date of the sale, the language "on the date of the sale" has been inserted after the word "determined." Also, to address the issue of a sale where the stock or interest is sold more than six months after the beginning of the taxable year, a sentence has been added that provides that if the interest is sold more than six (6) months into the current taxable year, then the average of the current taxable year's payroll and property factors shall be used. This provision has been added to address concerns that the earlier language, which provided that the taxpayer must refer back to the last twelve (12) month full tax period, would be, in some cases, looking back almost two (2) years prior to the sale and therefore too far back in connection with the sale in order to have an accurate view of the factors that existed at the time of the sale.

a. In the event that fifty (50) % or more of the amount of the assets of the corporation or pass-through entity sold, determined on the date of the sale and using the original cost basis of those assets, consist of real and/or tangible personal property, the sale of the stock or ownership interest will be assigned by averaging the payroll and property factors of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business. If, however, the sale occurs more than six (6) months into the current taxable year, then the average of the current taxable year's payroll and property factors shall be used.

8. Subsection (d)(1)(A)1.b. provides the rules of assignment of stock where more than 50% of the underlying assets of the corporation or pass-through entity sold consist of intangible property. For the same reasons stated above in paragraph 7, the same changes have been made here.

b. In the event that more than fifty (50) % of the amount of the assets of the corporation or pass-through entity sold, determined on the date of the sale and using the original costs basis of those assets, consist of intangible property, the sale of the stock or ownership interest will be assigned by using the sales factor of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records. If, however, the sale occurs more than six (6) months into the current taxable year, then the current taxable year's sales factor shall be used.

These sufficiently related changes are being made available to the public for the 15 day period required by Government Code section 11346.8, subdivision (c), and California Code of Regulations, title 1, section 44. Written comments regarding these changes will be accepted until 5:00 pm on November 14, 2011. The Franchise Tax Board is sending a copy of the proposed amendments to Regulation 25136 to all individuals who requested notification of such changes, as well as those who commented in writing to the previously noticed proposed amendments to Regulation 25136.

All inquiries and written comments concerning this notice should be directed to Melissa Potter 916-845-7831, FAX 916-843-2114, E-Mail Melissa.potter@ftb.ca.gov or Colleen Berwick at 916-845-3306, FAX 916-845-3648, E-Mail colleen.berwick@ftb.ca.gov; or by mail to the Legal Division, Attn: Melissa Potter or Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. The notice and the proposed amendments will also be made available at the Franchise Tax Board's website at <http://www.ftb.ca.gov/>.